Supreme Court of the United States

OCTOBER TERM, 1946.

No. 651

MORRIS INVESTMENT CORPORATION,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI AND BRIEF IN SUPPORT OF PETITION OF CERTIORARI.

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No.

Morris Investment Corporation,
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PETITION FOR WRIT OF CERTIORARI.

To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

The petition of Morris Investment Corporation herein respectfully shows to this Honorable Court:

A. Summary Statement of the Matter Involved.

This proceeding was a petition by the taxpayer, Morris Investment Corporation, addressed to the United States Circuit Court of Appeals for the Third Circuit for a review of the decision of the United States Tax Court ordering and deciding that there was a deficiency in Income Tax and Personal Holding Company Surtax of the petitioner for the year 1941 in the respective amounts of $6,965.89 and $13,301.67.

The matter was presented to the United States Tax Court and although the parties were unable to agree upon a Stipulation of Facts prior to trial, the trial developed no issue of fact.

Several questions were involved, all but one dealing with the interpretation of Section 24(b)(1) of the Internal Revenue Code as amended to and including 1941, which reads as follows:

> "*Losses disallowed.* In computing net income no deduction shall in any case be allowed in respect of losses from sales, or exchanges of property, * * *"

between members of a family and five others classes. The one exception dealt with the interpretation of Secs. 500-511 of the Internal Revenue Code imposing a surtax on certain Personal Holding Corporations. The questions presented are:

1. Whether subsection 24(b)(1) should be read as if it prohibited the deduction of *any* loss from *any* sale between members of any one of the six classes referred to in that subsection to the extent that losses may not be offset against gains when two or more transactions take place between the same parties and the subsection thus transformed from a provision denying losses into one creating fictitious profits.

2. Whether a sale by a corporation of seven classes of stocks owned by it to a controlling stockholder thereof, deliberately made as one integral sale for a lump sum consideration, without separate pricing of the different classes of stock (which would not have been made as separate sales), can be treated as separate sales of each class of stock for the purpose of charging the seller with taxable gains on some, while denying the offsetting losses of others.

3. Whether such a sale as described in "2" above can be treated as separate sales when the stocks sold were all active stocks dealt in daily upon the New York Stock Exchange and when for that reason no reasonable purpose of Congress can have been violated by the transaction.

4. Whether the Commissioner of Internal Revenue and the Courts can disregard the form of a sale deliberately made in that form to avoid the letter of said subsection and impose a tax upon the claim of looking through form to substance or upon some other ground when the intent and effect of the transaction are not and cannot possibly be contrary to any intent of Congress.

5. Whether the subsection goes even further and requires that in the case of a sale of a number of shares of the same class of stock of the same corporation made at the same time and for one lump sum price and as one transaction, it must be considered as a number of separate transactions for tax purposes merely because the shares were purchased at different times and at different prices. This to permit the imposition of a tax where some of the shares were purchased for less than the average selling price though the total selling price is not greater than the total purchase price.

6. Whether the intent of taxpayer to sell at *cost* can be disregarded where the lump sum price referred to above was developed by taking a figure which was the aggregate of the actual cost prices of the securities in question, because such lump sum was also the aggregate of the sales prices of the said securities on the New York Stock Exchange on the day *before* the sale.

7. In addition to the above questions concerning Sec. 24(b)(1) there was the further question whether Sections

500 to 511 of the Internal Revenue Code, imposing a surtax on Personal Holding Companies for failure to pay out dividends, intended to impose such surtax where a corporation had already paid out all of its earnings which were taxable in the hands of its stockholders and was a deficit corporation and where, for that reason, a distribution of the fictitious and unreal profits resulting from a sale of a number of securities for a lump sum price, would not give the taxpayer a deduction from net income.

Petitioner claims that the transaction in question must be taken as a whole and that no actual gain was realized therefrom and that said Section 24 (b)(1) of the Internal Revenue Code indicates no Congressional intention to the contrary.

Petitioner contends further that under the facts in this case it is obvious that the parties did not intend and could not have intended to circumvent the intent of Congress, which was to prohibit a taxpayer from taking fictitious losses or losses where control was unchanged though title passed.

And, finally, petitioner contends that it is erroneous to assign to Congress, as contended for by the Commissioner of Internal Revenue, an intent to create fictitious profits for the purpose of increasing taxation or an intent to impose heavy taxes based upon the failure to pay out such fictitious profits.

The Tax Court of the United States, as above stated, found on all points for the respondent and ordered and decided that the said deficiencies existed.

The petitioner petitioned the United States Circuit Court of Appeals, Third Circuit, for a review of the decision of the Tax Court of the United States. The United States Circuit Court of Appeals for the Third Circuit affirmed the

decision of the Tax Court of the United States on the 25th day of July, 1946, and the order affirming said decision was filed in the office of the Clerk on the same day (R. 43a-52a). The Order for Mandate of the United States Circuit Court of Appeals, Third Circuit, was issued on the 15th day of August, 1946.

All of the above questions were raised in briefs and arguments made before the Tax Court of the United States, and again before the Circuit Court of Appeals for the Third Circuit, and the judgments of those two courts could not have been rendered without deciding the questions.

B. Specification of Errors.

The Circuit Court of Appeals for the Third Circuit erred:

1. In affirming the order of the Tax Court of the United States and in determining that there was a deficiency of Income Tax of petitioner of $6,965.89 and of Personal Holding Company Surtax of Petitioner of $13,301.67 for the year 1941.

2. In failing to reverse the Order of the Tax Court of the United States and in failing to find that no deficiency either in Income Tax or in Personal Holding Company Surtax existed.

3. In failing to find and hold that said Section 24(b)(1) of the Internal Revenue Code, as amended to and including 1941, does not prohibit the offsetting of losses against profits in the case of more than one sale between members of any one of the six classes referred to in that section and does

not require the inclusion in profits of the total gains from all such transactions, regardless of offsetting losses.

4. In failing to find that there was no Congressional intent, as expressed in said Section 24(b)(1) of the Internal Revenue Code, that the provisions of that section be made the basis of creating fictitious profits out of lump sum transactions.

5. In failing to find and hold that where a transaction was deliberately made as one integral sale of a number of classes of stock, all traded in daily upon the New York Stock Exchange, and where the sale was made without separate pricing of the different classes of stock, that the said sale could not be treated as separate sales of each class for the purpose of charging the seller with taxable gains on some classes, while denying offsetting deductions on other classes, even though the one integral sale was made by a corporation to a controlling stockholder.

6. In failing to find and hold that where there is a single sale of a number of shares of the same class of stock of the same corporation as one transaction at one time and at one price per share, the single sale should not be subdivided and treated as separate sales of various portions of the said stock because it was purchased at different times and at different prices.

7. In failing to find and hold that an intent to sell stock at cost cannot be disregarded where the lump sum price at which the stock was sold was developed by taking a figure which was the aggregate of the actual cost of the various securities included in the sale, although such lump sum was also the aggregate of the closing prices on the New York Stock Exchange on the day before the sale for the said stock.

8. In failing to find that Sections 500 to 511 of the Internal Revenue Code were not intended to result in the imposition upon a Personal Holding Company of a Surtax for failure to pay out fictitious and unreal profits developed in the manner above stated under the provisions of Subsection 24(b)(1) of the Internal Revenue Code, when taxpayer had already paid out all of its real gains and was a deficit corporation.

C. Reasons Relied Upon for the Allowance of the Writ.

The questions relied upon are Federal questions, arising under the Internal Revenue Code, Section 24 (b)(1) and Sections 500 to 511, as amended, and are as above stated in "A", pages 1 to 5. These questions resolve themselves into three basic questions, one, what was the intent of Congress as to the effect and scope of Subsection 24 (b)(1) of the Internal Revenue Code, as amended to 1941?, two, has the Commissioner of Internal Revenue the power to disregard the form of a transaction where it did not and could not violate any intent of Congress or policy of taxation?, three, was it the intent of Congress by Secs. 500 to 511 of the Internal Revenue Code to impose a surtax upon Personal Holding Corporations for failure to distribute fictitious profits such as result from the procedure of separating a lump sum integral transaction into a number of separate sales and count the gains but ignore the losses when such corporation was a deficit corporation and the distribution would therefore not have been taxable to its stockholders?

Expanding those questions slightly: Did Congress intend by section 24(b)(1) that every lump sum sale of property where it was possible for the seller to compute approximately the losses and gains on individual compo-

nent parts of the property sold must be split into its component parts and taxed upon the gains thus computed, without offsetting the losses against such gains, thus creating taxable profits where no profits in fact existed?

Has the Commissioner of Internal Revenue any authority to disregard the form of the sale here in question and to declare it to be something different when the facts all show that there was not and could not have been any purpose to circumvent either the spirit or intent of any act of Congress?

Did Congress intend by Sec. 500 of the Internal Revenue Code to place a double penalty upon Personal Holding Corporations which sell to stockholders by imposing an 85% unavoidable surtax upon unreal and fictitious profits?

It is submitted that these are questions which will arise frequently in the case of ordinary corporations and of Personal Holding Companies and of transactions between individuals, members of the same family, and that its proper determination is a matter affecting many persons and large sums of money, and is a matter of great public interest and importance. This question has not been previously decided by this Court, although somewhat similar, yet distinguishable fact situations were decided against the taxpayer in *Lakeside Irrigation Company* v. *Commissioner*, 128 F. (2d) 418; *M. F. Reddington, Inc.* v. *Commissioner*, 131 F. (2d) 1014; *Matthews* v. *Squire*, 59 F. Supp. 827; *Mahaffy* v. *Commissioner*, 1 T. C. 176, and *W. A. Drake, Inc.* v. *Commissioner*, 3 T. C. 33, 39.

The first of the above cases was decided in 1942 and the others followed in quick succession within a period of about three years, indicating that the construction now placed upon said subdivision by the Commissioner of Internal Revenue is new, as the provision had been in effect for eight

years prior to 1942 and for five or six years before the preliminary determination against the *Irrigation Company.*

The fact that five cases involving lump sum sales have arisen and have been decided by various courts within a period of three years shows that the question is not a narrow one affecting few taxpayers, but is a broad one affecting many.

But the above tells only part of the story, for in all of the cases above referred to, the taxpayer was a corporation and the transaction involved the sale of shares of stock of various classes owned by it.

However, the subsection is not restricted to corporations, but extends to individuals of all classes where they belong to the same family and is not restricted to sales, but extends to all exchanges as well.

If there have been five cases in the Courts in the space of so short a time in the narrow field of corporate transfers of corporate stocks owned by a transferor, there must have been many times that number of transactions in the entire field covered by the subsection.

If the decisions of the lower courts are incorrect, or if they are distinguishable from transactions such as that in the case at bar, the failure of this Court to pass upon and define the situation clearly may prevent numerous wholly proper transactions, and to that extent interfere with business.

Obviously, while those decisions are unreversed and unrestricted, persons falling within the six classes of subdivision 24 (b) (1) have to indulge in circumlocutions, sell their stocks on the Stock Exchange, if they are of that kind, and pay brokers commissions, the rule being well settled that sales on the Stock Exchange even for the direct purpose of making losses are ~~not taxable.~~ valid and do n

fall within Sec 24(b)(1) 135 F 2d (2) 660;
5 T.C. 623

Moreover, the section affecting, as it does, all classes where there are certain relationships between the parties, has applied and will apply to many taxpayers who are unskilled in the law and for their guidance a plain statement by this Court of the effect of said subsection is important.

In the *Lakeside Irrigation Company* case, certiorari was denied by this Court (317 U. S. 666). That action by this Court cannot be considered as an approval of the decision of the Courts below, for the reason that the *Irrigation Company* failed to show that the case was one which involved either a conflict of decisions or a question of importance which it is in the public interest to have decided by the court of last resort. The facts in that case were by no means clear and it does not appear that there was any substantial basis for claiming that there had been an actual sale for a lump sum price.

D. Prayer for the Writ.

Wherefore, your petitioner respectfully prays that a Writ of Certiorari be issued to review the judgment of the Circuit Court of Appeals for the Third Circuit ordering and deciding that there was a deficiency in Income Tax and Personal Holding Company Surtax of said petitioner for the year 1941 in the respective amounts of $6,965.89 and $13,301.67; that said judgment be reversed and that your petitioner may have such other and further relief in the premises as may be just and proper.

Dated: New York, N. Y., October 24, 1946.

Morris Investment Corporation,
Petitioner,

By Edward L. Blackman,
Counsel for Petitioner,
120 Broadway,
New York, N. Y.

STATE OF NEW YORK, } ss.:
COUNTY OF NEW YORK, }

EDWARD L. BLACKMAN, being duly sworn, says:

That he is counsel for MORRIS INVESTMENT CORPORATION, the petitioner; that he prepared the foregoing petition and that the allegations thereof are true, as he thoroughly believes.

EDWARD L. BLACKMAN.

Subscribed and Sworn to before me }
this ~~23rd~~ 24th day of October, 1946. }

FLORENCE E. AVERY

(SEAL) FLORENCE E. AVERY
Notary Public, N. Y. State
Residing in Nassau County
Nassau Co. Clerk's No. 50
Certif. filed in N. Y. County
New York Co. Clk's No. 359 Reg. No. 240A7
Kings Co. Clk's No. 36, Reg. No. 183-A-7
My Commission Expires March 30, 1947

Supreme Court of the United States

October Term, 1946.

No. ....

Morris Investment Corporation,

Petitioner,

against

Commissioner of Internal Revenue,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

Opinions Below.

The memorandum opinion and findings of fact of the Tax Court of the United States (R. 13a-21a) are reported in 5 T. C. No. 67. The opinion of the United States Circuit Court of Appeals for the 3rd Circuit (R. 43a-50a) is reported in 156 Fed. 2d 748.

II.

Jurisdiction.

1. The statutory provision believed by the petitioner to sustain the jurisdiction of this Court is Section 240 of the Judicial Code, as amended by the Act of February 13th, 1925, 43 Stat. 938 (24 U. S. C. A. Sec. 347).

2. The Statute involved is the Internal Revenue Code, 53 Stat. 1-503. The pertinent provisions of this Statute are as follows:

"(b) *Losses from Sales or Exchanges of Property.*

"(1) *Losses disallowed.* In computing net income no deduction shall in any case be allowed in respect of losses from sales, or exchanges of property, directly or indirectly—

(A) Between members of a family, as defined in paragraph (2)(D).

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual." (Internal Revenue Code 1929, Sec. 24 (b)(1)).

and Sections 500 to 511 of said Code imposing a surtax of 85% on undistributed current earnings of Personal Holding Companies.

3. The order of affirmance of the Circuit Court of Appeals, Third Circuit, was issued on the 25th day of July, 1946. This petition was docketed on the 25th day of October, 1946.

4. The controlling questions relied upon herein are whether, for purposes of taxation, an *integral lump sum* sale of several classes of stock not separately priced and made purposely in that form and purposely at cost can be split up into a number of small transactions (none of which would have been made by the seller without the others), because concededly the lump sum price was the aggregate of the market prices of all classes as well as the aggregate cost thereof and taxable gains be derived therefrom, by

finding a taxable gain whenever the market price was above cost but by ignoring all cases where cost was above market. The taxpayer contends that the only purpose and effect of the subsection quoted was to prevent taxpayers from *reducing* taxable income by losses incurred in cases falling within the classifications set out in Section 24 (b)(1). The Commissioner of Internal Revenue interprets the subsection in such manner that any transaction between members of a family or between a corporation and a controlling stockholder made in good faith and resulting in an actual loss can be transformed into a fictitious gain and increase taxable income.

The above question was a principal issue in this case before the Tax Court of the United States and before the Circuit Court of Appeals of the Third Circuit. There was also the issue of whether or not an integral lump sum sale such as above described could be treated as above described where the stocks sold were all actively traded in daily upon the New York Stock Exchange, and where, therefore, the sale in the form adopted did not and could not have violated or circumvented any intent of Sec. 24 (b)(1) or any other Act of Congress.

There was the further issue whether or not it was the intent of Congress that a personal holding company should be penalized and taxed 85% additional on such fictitious profits computed under Sec. 24 (b)(1), as above described, because it could not pay them out as *taxable dividends* after it had distributed all of its actual gains taxable to its stockholders.

There was the still further question whether or not in the circumstances above stated shares of the same class of the same company sold at the same time and same price per share and as a part of such integral lump sum sale

can be divided into two or more separate sales at the *same price* per share in order to create a taxable gain in those cases where some of the shares were purchased below market, while ignoring the fact that the remainder of such shares had been purchased above market.

III.

Specification of Errors.

The Circuit Court of Appeals for the Third Circuit erred:

1. In affirming the order of the Tax Court of the United States and in determining that there was a deficiency of Income Tax of petitioner of $6,965.89 and of Personal Holding Company Surtax of Petitioner of $13,301.67 for the year 1941.

2. In failing to reverse the Order of the Tax Court of the United States and in failing to find that no deficiency either in Income Tax or in Personal Holding Company Surtax existed.

3. In failing to find and hold that said Section 24(b)(1) of the Internal Revenue Code, as amended to and including 1941, does not prohibit the offsetting of losses against profits in the case of more than one sale between members of any one of the six classes referred to in that section and does not require the inclusion in profits of the total gains from all such transactions, regardless of offsetting losses.

4. In failing to find that there was no Congressional intent, as expressed in said Section 24(b)(1) of the Internal Revenue Code, that the provisions of that section be made the basis of creating fictitious profits out of lump sum transactions.

5. In failing to find and hold that where a transaction was deliberately made as one integral sale of a number of classes of stock, all traded in daily upon the New York Stock Exchange, and where the sale was made without separate pricing of the different classes of stock, that the said sale could not be treated as separate sales of each class for the purpose of charging the seller with taxable gains on some classes, while denying offsetting deductions on other classes, even though the one integral sale was made by a corporation to a controlling stockholder.

6. In failing to find and hold that where there is a single sale of a number of shares of the same class of stock of the same corporation as one transaction at one time and at one price per share, the single sale should not be subdivided and treated as separate sales of various portions of the said stock because it was purchased at different times and at different prices.

7. In failing to find and hold that an intent to sell stock at cost cannot be disregarded where the lump sum price at which the stock was sold was developed by taking a figure which was the aggregate of the actual cost of the various securities included in the sale, although such lump sum was also the aggregate of the closing prices on the New York Stock Exchange on the day before the sale for the said stock.

8. In failing to find that Sections 500 to 511 of the Internal Revenue Code were not intended to result in the imposition upon a Personal Holding Company of a Surtax for failure to pay out fictitious and unreal profits developed in the manner above stated under the provisions of Subsection 24(b)(1) of the Internal Revenue Code, when taxpayer had already paid out all of its real gains and was a deficit corporation.

IV.

Statement of the Case.

The facts in this case are few and though not stipulated are undisputed, respondent having called no witnesses. The statement of evidence consists of nine pages of testimony and two exhibits.

The following facts were found by the Tax Court (R. 13a to 18a):

Petitioner was incorporated December 31, 1928, under the Laws of Delaware, and for the taxable year 1941 filed its Corporation Income and Declared Value Excess Profits Tax Return and Personal Holding Company Tax Return with the Collector of Internal Revenue for the Fifth District of New Jersey, at Newark, New Jersey. During the taxable year 1941, the petitioner was a Personal Holding Company, of which Mrs. Katherine Clark Morris, hereinafter called Mrs. Morris, was the President. During that year the petitioner had outstanding 31,000 shares of Common Capital Stock of which Mrs. Morris owned 91.87%. The remainder of the said stock was held by the Estate of Mrs. Morris's late husband, Lewis R. Morris, Mrs. John H. Hall, Jr., her daughter, and John H. Hall, Jr., her son-in-law. The stocks held by the Estate of Lewis R. Morris, Mrs. John H. Hall, Jr. and John H. Hall, Jr. were gifts from Mrs. Morris. Sometime prior to September 6th, 1941, Mrs. Morris had arranged to create three trusts for the benefit of her daughter and grandchildren (Findings of Fact #1 to 3, R. 13a-14a).

The Directors of the petitioner during the taxable year 1941 were Mrs. Morris, Edward L. Blackman and John H. Hall, Jr. (Finding of Fact #5, R. 14a).

A Special Meeting of the Board of Directors of Petitioner was held at 10:45 A. M. on September 16th, 1941, at the office of Edward L. Blackman at 120 Broadway, New

York, N. Y., the time and place having been fixed by consent of all the Directors of the corporation. There were present at this meeting Mrs. Morris, Edward L. Blackman, John H. Hall, Jr. and Harry H. St. Clair, the latter being the Treasurer and Assistant Secretary of Petitioner (Finding of Fact #6, R. 14a).

At this Special Meeting of the Board of Directors, the following proceedings were had:

Mr. Blackman announced that the corporation had received from Mrs. Morris an offer to purchase for the sum of $131,368.75 the following stocks owned by the corporation:

700 shares of capital stock of Amerada Corporation;
150 shares of capital stock of American Telephone and Telegraph Company;
500 shares of capital stock of Union Carbide and Carbon Corporation;
25 shares of common stock of Atchison, Topeka and Santa Fe Railway Co.;
200 shares of common stock of Chesapeake and Ohio Railway Company;
150 shares of common stock of Union Pacific Railroad Company;
150 shares of common stock of Corn Products Refining Company (Finding of Fact #7, R. 15a).

Mr. Blackman stated that in his opinion the offer was a good one and recommended that it be accepted. Mr. Hall thereupon moved that the corporation accept the offer of Mrs. Morris and that the officers of the corporation be directed to effect such sale and make delivery of the said stocks to Mrs. Morris or to her order and to execute and deliver all requisite assignments and documents of transfer of the stocks in accordance with their authority and the

standing resolution of the Board of Directors adopted January 6, 1932.

The motion was seconded by Mr. Blackman and thereupon put to a vote. Upon the affirmative votes of Messrs. Blackman and Hall, Mrs. Morris not voting, the motion was carried.

Mr. Hall thereupon moved the adoption of the following resolution:

> "Resolved that the Treasurer of this corporation be and he is hereby authorized to accept in payment for the stocks today sold to K. Clark Morris her promissory note, dated September 16, 1941, to pay $131,368.75 ninety days after date to Morris Investment Corporation with interest at the rate of 3%" (Finding of Fact #7, R. 16a).

The facts with respect to the development of said purchase price of $131,368.75 are shown in findings "7", "9" and "11" (R. 14a, 17a, 18a), but this matter is clearly and succinctly stated by St. Clair, the treasurer, as follows:

> "I prepared a list of stocks with Stock Exchange prices which Mr. Hall referred to and which he stated I showed him on the 15th or 16th of September. I prepared that list at Mr. Blackman's request. He wanted me to give him a list of stocks that would aggregate $131,000 or $132,000. I mean that the value of the stocks would aggregate that figure *and that the stocks would have an acquisition value of about the same amount as close as I could figure it,* and that the stocks were of a sufficient number of shares so that they could be split up without getting fractional amounts. They were also to be active stocks which were traded in daily on the New York Stock Exchange" (R., p. 24a).

After Mrs. Morris' offer had been accepted and the sale made upon the terms above stated, Mr. St. Clair suggested

that specific resolutions be adopted with respect to the sale and transfer of the shares of American Telephone and Telegraph Co. and Chesapeake and Ohio Railway Co., as the transfer agents of those corporations would probably not transfer those stocks upon the sole authority of the standing resolution of the Morris Investment Company as to sale and transfer of securities. Resolutions were thereupon adopted, providing that the petitioner sell to Mrs. Morris 50 shares of American Telephone and Telegraph Company stock, represented by Certificate NM-44657 at a price of \$154 ⅝ per share, and 100 shares represented by Certificate gg-38748 at a price of \$154⅝ per share, and 200 shares of the common stock of the Chesapeake & Ohio Railway Company, represented by Certificates C-59711 and C-59712, at a price of \$37.25 per share; and that the officers be empowered to transfer said stock (Finding of Fact #7, R. 16a). As stated by St. Clair these resolutions were merely surplusage and made to meet possible objections from fussy transfer agents (Finding #7, R., p. 28a).

A list of the stocks included in the sale by the corporation to Mrs. Morris was set out by the Treasurer of the Company in the Company's Income Tax Return for the taxable year 1941, and in this return the Treasurer set forth as required by the income tax form the cost and date of purchase of each share of the various stocks included in the sale and the amount at which the various stocks were valued in arriving at the lump sum figure of \$131,368.75 but attached a note explaining the transaction (Findings of Fact #9 and 11, R. 17a and 18a).

V.

Summary of Argument.

First Point. The intent of Subsection 24(b)(1) is not clear and a proper and the best source from which to determine the correct interpreta-

tion thereof is its legislative history. Such history sustains appellant's construction.

Second Point. The transaction in question was one indivisible sale for a lump sum and not a number of separate sales some below and some above cost.

Third Point. The transaction here in question consisting of the sale of stocks all of which were traded in daily upon the New York Stock Exchange did not and could not circumvent the intent of Congress or its policy of taxation.

Fourth Point. The Commissioner of Internal Revenue has no power to disregard the plain intent of taxpayer to make one indivisible sale and claim that it made 20 separate sales in the face of the fact that the transaction did not and *could not* circumvent the intent of Congress.

Fifth Point. Regardless of all other considerations, no taxable gain can be found from the transaction here in question because the parties intended to sell and did sell at cost.

Sixth Point. The facts in the case at bar present fundamental differences from those in the *Reddington, Lakeside Irrigation Co.* and *Mahaffey* cases, and this case is clearly distinguishable from those cases.

Seventh Point. The transactions relied upon by the Tax Court and the Circuit Court of Appeals took place after the sale to Mrs. Morris and in no wise contradict appellant's claim of one indivisible transaction.

Eighth Point. Whatever may be said in support of considering the sale of each of the several classes of stock as a separate sale, the sale of certificates of the same class at the same time and for the same price per share should not be considered separate sales.

NINTH POINT. The purpose of Congress in enacting Sections 500 to 511 of the Internal Revenue Code imposing a surtax of 85% on undistributed current earnings of personal holding companies was intended to force distributions which would be taxable in the hands of stockholders and was not intended to penalize a corporation by imposing a surtax in a case such as this.

FIRST POINT.

The intent of Subsection 24(b)(1) is not clear and a proper and the best source from which to determine the correct interpretation thereof is its legislative history. Such history sustains appellant's construction.

The above-mentioned Subsection provides as follows:

"(b) *Losses from Sales or Exchanges of Property.*

"(1) *Losses disallowed.* In computing net income no deduction shall in any case be allowed in respect of losses from sales, or exchanges of property, directly or indirectly—

(A) Between members of a family, as defined in paragraph (2)(D).

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual."

Subdivisions C, D, E, and F of the subsection provide other classes where losses are disallowed.

The Taxpayer contends that the sole purpose, intent and effect of the Subsection was to prevent the reduction of taxable income from other sources by losses incurred in cases falling within any of its six Subdivisions. On the other

hand, the Commissioner of Internal Revenue gives an interpretation to the Subsection which stretches it to the point where transactions between members of a family or between a corporation and a controlling stockholder made in good faith and resulting in an actual loss are transformed into fictitious gains and *increase* taxable income.

Thus, if one farmer sold to another a large number of horses and sheep and if the sales price of the horses was $50,000 in excess of their cost but the sales price of the sheep was $60,000 less than their cost, the farmer transferring the same would make an actual loss of $10,000, which loss he could deduct from his income from other sources, subject to certain limitations. If the two farmers were father and son the Commissioner of Internal Revenue contends that Section 24(b)(1) transforms such actual loss into a fictitious profit of $50,000 by requiring that the gain on the horses be added to other income and the loss on the sheep be ignored. Appellant, on the other hand, contends that said Subsection prohibits the deduction of the loss of $10,000 resulting from the family sale, but goes no further, such prohibition being sufficient to carry out the intent of Congress as stated by appellant above, and that an intent to saddle a taxable gain of $50,000 on the seller would be too harsh and unreasonable to impute lightly to Congress.

Respondent's interpretation of Section 24(b)(1) provides harsher treatment than that accorded to fraudulent transactions and gambling losses.

The prohibition of the Subsection is: "*In computing net income* no deduction shall in any case be allowed *in respect of losses* from *sales* or *exchanges* of property" * * *. The words "in any case" refer to "in computing net income" or to "deduction" and not to "losses" or to "sales" and the provision is not that no deduction shall

be allowed in respect of *any* loss from *any* sale or exchange of property to which any of said subdivisions applies.

Congress must have envisioned the probability of several transactions between persons falling within one of the six classifications of said subsection and if the intent of Congrèss had been that offered by the Commissioner of Internal Revenue, it would have been so easy for it to have provided as follows: In computing net income, no deduction shall be allowed for *any loss* arising from *any sale* or exchange of property, directly or indirectly * * *.

The language of subsection 24(b)(1) is not clear and free from ambiguity and the interpretation offered by taxpayer is certainly a reasonable one.

In these circumstances, it is proper to show the intent of Congress from matters *de hors* the words of the Subsection.

Indeed, even where the language of a statute is clear and unambiguous, the intent of Congress may be shown to be different from the letter of the law.

> *Holy Trinity Church* v. *U. S.*, 143 U. S. 457, 472;
> *Lau Ow Bew* v. *U. S.*, 144 U. S. 47, 59;
> *Haggar* v. *Helvering*, 308 U. S. 389.

Thus it is proper to refer to the legislative history of said subsection 24(b)(1) to determine the intent of Congress with respect thereto.

The above quoted provisions of said subsection appeared first in the 1934 Revenue Act as Section 24(a)(6). The language of the present Act, however, is identical with that of the previous Act, and therefore the intent of the present Act may be shown by the legislative history of said Section 24(a)(6).

The intent of Congress in enacting that Section and the meaning thereof are clearly and directly shown by the following statement of the proponents of the bill which became Section 24(a)(6):

> "We have removed the temptation from tax-dodgers who transfer securities or other property from one member of a family to another *in order to deduct capital loss against ordinary income*" (Congressional Record Vol. 78, p. 2663) (Italics ours).

As the bill passed through sub-committees and committees of both the House and the Senate, the same intent was iterated and reiterated. Thus, the preliminary report of the Subcommittee of the Committee on Ways and Means, 73rd Congress, 2d Session, December 4, 1933, stated with respect to the bill, as follows (Pages 14-15 of Report):

> "(8) DISALLOWANCE OF LOSSES BETWEEN MEMBERS OF FAMILY.
>
> "It is proposed to add to section 24(a) of existing law a paragraph which will *deny losses to be taken* in the *case of sales or exchanges* of property between members of a family, or between a shareholder and a corporation in which such shareholder owns a majority of the voting stock. The term 'family' is defined to include brothers and sisters, spouse, ancestors, and lineal descendants.
>
> "*Many instances have been brought to light where transactions have taken place for the sole purpose of taking a loss for income tax purposes. It is believed that the recommendation of the subcommittee, if followed, will effectually close this opportunity for tax avoidance*" (Italics supplied).

The Ways and Means Committee itself accepted the recommendation of the Subcommittee in almost identical terms as above (Report No. 704, 73rd Cong., 2d Sess. 1934).

When the matter came before the Senate, the proposed Section 24(a)(6) was again commented upon in the same way (Senate Report No. 558, 73rd Cong., 2d Sess., p. 27).

In the discussion of the bill before the House and Senate its purpose was stated repeatedly in language similar or identical with that above quoted. (Congressional Record, Vol. 78, page 2511; Congressional Record, Vol. 78, pages 5847-8.)

Finally the Bill came up for passage and Representative Samuel B. Hill, Chairman of the Subcommittee of the Ways and Means Committee of the House, stated on the floor of Congress:

> "Also, since we have provided in this bill against transactions between members of the same families, whereby a man may transfer to his wife, to his daughter, his son or father, or any member of his family in direct line of ascent or descent, we have removed the temptation from tax dodgers who transfer securities or other property from one member of a family to another *in order to deduct a capital loss against ordinary income.*" (Congressional Record, Vol. 78, p. 2663). (Italics supplied.)

Thus, from both the House Committee Reports and the Senate Committee Report, and from the remarks of Representatives and Senators concerning the purpose of including Section 24(a)(6) in the Revenue Act of 1934, we find the intention of Congress to be direct and simple and to the effect that a taxpayer should not be allowed to *reduce* his taxable income by a transaction or transactions between himself and a member of his family, or between himself and his controlled corporation.

The above quotations show not only the reason for the legislation and the evil which it was sought to correct, but the interpretation which Congress itself put upon the language of the Bill which later was enacted as law *in the identical terms.*

The legislative history of Sec. 24 (a)(6) of the above Revenue Act is the strongest and clearest that petitioner has any knowledge of, but becomes even stronger and clearer when considered in relation with current events of that period, from which it is clear that the section was passed as a definite answer to and means of preventing transactions such as that in the notorious case of Charles Mitchell, former President of the National City Bank of New York.

Mitchell transferred to his wife a huge amount of bank stock the control of which he did not intend to part with and took a loss of hundreds of thousands of dollars thereon, which loss he offset against large gains, and thereafter bought back the stock from his wife.

Mitchell was acquitted of fraud by a jury in a criminal prosecution by the Government on June 22, 1933. (See record in *Mitchell* v. *Commissioner of Internal Revenue,* 89 Fed. Rep. Second Series, p. 873; record on appeal, at p. 695.)

This case was a *cause celebre* and filled the newspapers for weeks and the very next year after said acquittal said subdivision 24 (a) (6) was enacted as law. However, the bill which became 24 (a) (6) and the discussions in Congress which preceded such enactment followed close upon the heels of that acquittal, and we find reports as early as December 4, 1933 on the bill which was finally enacted as said subdivision (73rd Congress, 2d Session, Dec. 4, 1933).

Moreover, while we are dealing here only with subdivision "B" of subsection 24(b)(1), said subsection applies to

classifications in six subdivisions "A," "B," "C," "D," "E" and "F" and denies deductions in the case of transactions between members of any of said classes. Therefore the proper interpretation of said subsection 24(b)(1) must be fairly applicable to all of said subdivisions.

To put a stop to a practice which was frequently resorted to for the sole purpose of reducing net taxable income was a reasonable and required procedure on the part of Congress. On the other hand, to prevent proper transactions between members of each of six classes of individuals or corporations not actuated by any desire to reduce taxable income and which do not have that effect is a very different matter and should not be considered as the intent of Congress.

Such a law as the Commissioner of Internal Revenue construes 24(b)(1) to be would not produce taxes. It would prevent sales.

But why should such sales be prevented? How can the government be injured thereby?

If gain result from all the sales considered together taxable income is increased thereby, but if loss result the loss is not deducted.

The contention of taxpayer set forth in the preceding point is inconsistent with the views expressed in the opinions of the Courts in the *Lakeside Irrigation Company* and *Reddington Cases*, discussed hereinafter. However, Petitioner is so firmly of the opinion that the conclusions reached in the *Lakeside Irrigation Case* (5th Circuit) and the *Reddington Case* (2nd Circuit) cannot be reconciled with the plain intent of Congress in enacting Subsection 24(b)(1) of the Code that it gives this point first place in its brief.

The following points, however, are not inconsistent with the *Irrigation Company* and *Reddington* decisions and are based upon facts which distinguish this case from those.

SECOND POINT.

The transaction in question was one indivisible sale for a lump sum and not a number of separate sales some below and some above cost.

The offer of Mrs. Morris was to purchase a certain list of stocks for a lump sum amount for the whole. No offer was made to purchase separately any class or classes of the stocks involved. Separate prices for the different classes of stock were deliberately avoided. The resolution of the Board of Directors accepted the offer of Mrs. Morris. (See findings of Tax Court set forth at pp. 16 and 17, *supra.*) The transaction was deliberately put through in the manner shown above and obviously there would have been no transaction on any basis of separate sales.

The general rule that transactions intended as a unit cannot be treated as separable for tax purposes is established by a multitude of authorities familiar to this Court.

> *Pearson* v. *McGraw,* 308 U. S. 313;
> *Minnesota Tea Co. v. Helvering,* 302 U. S. 609;
> *Helvering* v. *Bashford,* 302 U. S. 454, 458;
> *Bassick* v. *Commissioner,* 85 F. (2d) 8 (C. C. A. 2d), cert. den. 299 U. S. 592;
> *Ahles Realty Corporation* v. *Commissioner,* 71 F. (2d) 150 (C. C. A. 2d), cert. den. 293 U. S. 611;

Thus, taxpayer deliberately avoided the letter of Section 24(b)(1)(B) no matter how the section is construed. The intent of Mrs. Morris and the method by which she arrived at the purchase price are irrelevant unless they constitute an attempt to accomplish something contrary to the intent of Congress.

THIRD POINT.

The transaction here in question consisting of the sale of stocks all of which were traded in daily upon the New York Stock Exchange did not and could not circumvent the intent of Congress or its policy of taxation.

Appellant believes that it has shown in its First Point the true intent of Congress in enacting subsection 24(b)(1).

Let us concede however for the purposes of argument that Congress intended to go further. What then is the extreme extent to which it may reasonably be contended that Congress intended to go in denying losses arising from transactions between members of any of the six subdivisions of said subsection 24(b)(1)?

In considering this intent, it must be borne in mind that the subsection is not limited to Personal Holding Corporations, but applies to individuals and to all corporations where there is 50% ownership or control, direct or indirect, and to many other cases as well; that it applies to exchanges as well as to sales; and that by reason of its broad application to large classes who would not be familiar with law, it should not be given a harsh or extreme effect, but should be limited to reasonable objectives and the preventing of abuses.

In view of all of the foregoing, and in view of the legislative history of the section discussed at length at pages 19 to 25, *supra*, taxpayer submits that the extreme extent to which it may be considered that Congress intended to go, is that of denying deductions in every case of a sale or transfer where the parties intended or might have intended that seller retain control over the property

sold and where for that reason the sale is not, or may not be truly arms length.

There is no reason why a *bona fide* loss from an outright sale should be disallowed because made between members of a family, except that such transactions are suspect in that they may be made with the intent that the seller still control the property sold.

It might be argued that in every class of transaction included in each of the six paragraphs of subsection 24 (b)(1) the seller might well retain control of the property sold and that the intent of Congress extended to the point of prohibiting the taking of losses from any sale where such continued control did exist or might exist.

The case at bar does not violate that intent *and cannot violate it.* The undisputed proof is that all of the securities sold were stocks actively traded in daily upon the New York Stock Exchange (R. p. 24a).

Thus, there could be no possible object in a taxpayer's seeking to retain control after sale of a small number of shares of stock of a class actively traded in on the Stock Exchange, and it could not have been the intent of Congress to prevent or penalize such a transaction.

Of course, if the form of the transaction had fallen within the letter of said 24(b)(1), the Court might decline to relieve the taxpayer. This is not that case, however. Here the letter of the law was deliberately avoided and the Commissioner demands the right to disregard what the parties actually did and to hold that their intent was something quite different. But this right to look through form to substance exists only where the form is used to circumvent Congress. (See next point.)

FOURTH POINT.

The Commissioner of Internal Revenue has no power to disregard the plain intent of taxpayer to make one indivisible sale and claim that it made 20 separate sales in the face of the fact that the transaction did not and *could not* circumvent the intent of Congress.

As all of the stocks sold to Mrs. Morris were active stocks, traded in daily upon the New York Stock Exchange (R., p. 24a), taxpayer could have sold those stocks upon the Exchange, instead of making a private sale to Mrs. Morris.

Instead of going through circumlocutions, and paying brokerage commissions, the stocks were transferred to Mrs. Morris and by her to the three Trust Companies (Finding of Fact, No. 8, R. 16a).

As stated in the previous point, if the form of the sale to Mrs. Morris had been such that the letter of Subsection 24(b)(1)(B) applied, then there would be room for argument that the lack of any improper purpose would not prevent the application of the said Subsection.

So too, if the intent of the transaction ran counter to or circumvented the purpose of Congress in enacting said Subsection, there would be grounds for arguing that the form of the transaction should be ignored and the lump sum sale divided up and taxed as several separate sales.

However, as the said Subsection does not apply literally to the transaction in question, and as the spirit of the said Subsection is not violated or circumvented by what was done, there is no right or reason why the formal sale made by the taxpayer to Mrs. Morris as one integral sale of a

number of securities for a lump sum consideration, without separate pricing of the different securities, should be divided into 20 separate sales, and losses and gains imputed which the parties deliberately avoided.

Not only was there no intent to accomplish something contrary to the purpose of said Subsection 24(b)(1)(B), but the fundamental and indisputable facts preclude the possibility of such evasion or circumvention.

Thus, the Commissioner of Internal Revenue was not called upon and could not have been called upon to litigate any question of good faith or lack of intent to circumvent the said Subsection. There could have been no such intent with respect to a sale of active Stock Exchange Securities.

FIFTH POINT.

Regardless of all other considerations, no taxable gain can be found from the transaction here in question because the parties intended to sell and did sell at cost.

Even if the Commissioner of Internal Revenue has the right to ignore the form of the transaction between Mrs. Morris and the taxpayer on September 16, 1941, and to consider what took place prior to September 16 and the intent of the parties as disclosed thereby, Subsection 24(b)(1)B still would not apply. That section relates only to the disallowance of losses and here the parties did not intend to, and in fact did not sell *any* of the stocks in question at a loss.

The Commissioner of Internal Revenue treats the transaction as if the parties had selected a list of stocks for sale, then found the market value of each class of stock and applied that value to the number of shares of each class,

then disregarding the separate prices, had used the lump sum total as the purchase price to avoid the provisions of subsection 24(b)(1)B. (90 day letter, R., p. 10a, lines 5 and 10.) But that was not the nature of the transaction at all.

The stocks sold to Mrs. Morris for approximately $131,000 were sold at that price because that was the cost thereof.

The testimony of the Treasurer with respect to this is as follows:

> "I was Treasurer of the Petitioner corporation in 1941 and have been Treasurer for at least 13 years, possibly longer, ever since shortly after the Company was incorporated.
>
> I prepared a list of stocks with Stock Exchange prices which Mr. Hall referred to and which he stated I showed him on the 15th or 16th of September. I prepared that list at Mr. Blackman's request. He wanted me to give him a list of stocks that would aggregate $131,000 or $132,000. I mean that the value of the stocks would aggregate that figure *and that the stocks would have an acquisition value of about the same amount as close as I could figure it,* and that the stocks were of a sufficient number of shares so that they could be split up without getting fractional amounts. They were also to be active stocks which were traded in daily on the New York Stock Exchange" (R., p. 24a).

Thus, it was the intent of the parties to sell at cost. The actual selling price of the 1,800 shares of stock sold came within $198.25 of the aggregate cost of those same stocks, as finally computed, which is a difference of only ⅛th of $1 per share (Finding of Fact No. 10, R., p. 17a).

While it is true that the selling price was the aggregate of the closing prices of the day prior to the sale, the funda-

mental and controlling intent of the parties was to avoid profit by selling at cost.

The reason why the exact cost of the securities sold was not used is that the exact cost was somewhat difficult of ascertainment and required elaborate computations. In most instances rights had been received in connection with these stocks and some or all of such rights had been sold and therefore there were credits against the original purchase price (See computation of costs attached to income tax return, Exhibit A, R., pp. 39a-42a).

No provision of the Revenue Act is violated by a sale at cost even though seller and purchaser are closely related and value is far in excess of cost. Nor can the Commissioner of Internal Revenue find a taxable gain from a sale at cost.

Fincke v. *Commissioner,* 39 B. T. A. 510.

SIXTH POINT.

The facts in the case at bar present fundamental differences from those in the *Reddington, Lakeside Irrigation Co.* and *Mahaffey* cases, and this case is clearly distinguishable from those cases.

The provisions of Sec. 24(b)(1)(B) of the Internal Revenue Code or predecessor provisions have been applied by the Courts to the particular fact situations in *M. F. Reddington Inc.* v. *Commissioner* (131 F(2)1014), in *Lakeside Irrigation Company* v. *Commissioner* (128 F(2)418; cert. den. 317 U. S. 666) and in the *Mahaffey* case (I. T. C. 176).

In all three of those cases (which are three nearest cases on the subject) the parties fixed a *separate price* (the market price) for each of a number of different classes

of stock involved in the transaction; the price paid had no relation to cost and the parties relied upon a unity of purpose, a transfer at one time and a lump payment as making the transaction one and individible and as not within the provisions of the section in question.

In all three cases the Courts held that insofar as the application of Sec. 24(a)(6) of the Revenue Act of 1936 was concerned the transaction should be considered and taxed as a number of separate sales. Said section is the predecessor of Sec. 24(b)(1)(B) of the Code and the terms so far as concern us here are identical, as stated *supra*, page 21.

In the *Reddington* case, the Company sold a list of twenty-one securities. The government stressed the point that a separate price was fixed for each lot. (See Government's Brief in the *Reddington* case, p. 6.)

Moreover, in that case it was recognized by the Court and by the parties that the claim to a single transaction was based upon the fact that the securities were all sold on the same day and that one check was given for the entire aggregate price and that one purpose actuated the sale. Thus, the Circuit Court of Appeals, stating the taxpayer's contention, says:

> "Taxpayer grants that the Commissioner would be correct if the sales of the twenty-one items had consisted of twenty-one separate sales, each made on a separate day, but it argues that here the situation is different in two significant respects:
>
> "(1) The *sales* were made simultaneously with the payment of the purchase price, by agreement, in a lump sum. (Italics ours.)
>
> "(2) Reddington's purpose was to protect his daughter's interest in the taxpayer" (p. 1015).

From the foregoing, and from the entire record, it appears beyond question that Reddington contracted to purchase twenty-one different classes of securities at a separate agreed price for each item and recognized that there were 21 separate sales, but attempted to avoid the application of said Sec. 24(a)(6) by providing that he would purchase them all at one time and would pay for them all in one lump sum amount, which he did.

He considered that thereby the transaction was made indivisible.

There was no formal agreement of purchase and sale shown and the case of the taxpayer is not strengthened by the resolution of its Board of Directors, which was very general, and which *was made several days after the purchase and sale had taken place*, and which was termed a ratification thereof, and which might well have been an afterthought to give support to the lump sum view of the transaction.

While Petitioner does not concede the correctness of the decision in the *Reddington* case, it does concede that the transacton there might technically be viewed as twenty-one separate sales.

The situation in the case at bar is very different. Here the purchase and sale was evidenced by the offer of Mrs. Morris to the corporation and the resolution of the Board accepting her offer. Here there was no pricing of the various securities. On the contrary there was a deliberate avoidance of anything of the kind (Petitioner's Exhibit 1, R., pp. 29a-30a).

That omission was deliberate and for the purpose of avoiding the situation which was the foundation for the decisions against the three Companies above referred to. That fact alone is sufficient to distinguish the case at bar from the decisions in the cases above referred to.

Moreover, an important factor in the case at bar, which did not exist in any of the other cases, was the fact that Mrs. Morris purchased the securities in question at their cost, and this was deliberate and intentional, and no accident. True, the market value of these securities was also almost exactly the price paid by Mrs. Morris, but Mrs. Morris, in making her offer to purchase, restricted her offer to the particular securities in question for the definite purpose of purchasing them at cost (R., pp. 24a, 29a, 30a).

The decision in the *Reddington* case even gives some support to the petitioner.

In that case the Circuit Court of Appeals sustained the treatment of the lump sum sale as a number of separate sales for tax purposes upon the ground that such practice was necessary to prevent evasions, saying:

> "Taxpayer, as noted, admits that the net-loss concept would not apply if the twenty-one sales had been made on separate dates. It is difficult to see why such a concept should be implied merely because the sales here were lumped together. Were that regarded as a differentiating fact, it would be easy to avoid the Congressional purpose."

In answer to the contention of the *Reddington Co.* that the Court below had found good faith, the Circuit Court of Appeals said that the burden of determining whether or not good faith is present should not be imposed upon the Commissioner. On this subject it said:

> "The successful avoidance of the obligation to pay taxes should not, ordinarily, be made to turn on the ability of the Commissioner to show that the taxpayer had no intention to avoid that obligation—in the absence of statutory language, expressly or by clear implication, making that factor the criterion—for otherwise the administration of the tax laws will be rendered too difficult."

Finally, in concluding its opinion the Court recognized that a general rule requiring the splitting up in all cases of a lump sum purchase of several items would not be authorized and might work injustice and said that there might be cases where the items sold should be treated as one sale.

What does all the above mean? What can it mean, except that when there is the possibility of evasion of the intent of Congress by a lump sum payment for a number of items the lump sum sale may be split up. The above rule lets out petitioner.

There can not possibly be any evasion of the intent of Section 24 (b) (1) (B) by a sale of small quantities of active New York Stock Exchange stocks (See Fourth Point).

In this connection it should be noted that Reddington's control was continued.

In the *Irrigation Company* case (a weak case, weakly presented), the transaction related to a *future* purchase and sale of three or four different classes of securities at market value *at the time of transfer*. Hence, it was inevitable that there be a separate market value or price fixed for each class.

Moreover, in the *Irrigation Co.* case the facts were by no means clear and it does not appear that there was any substantial basis for claiming that there had been an actual sale for a lump-sum price. The first mention of the lump-sum price is contained in the resolution of the Board of Directors ratifying the sale and providing for a lump-sum credit. Apparently the sale, itself, took place previously, and there is nothing to show the terms thereof.

Finally the transaction might well have been an attempt to circumvent subsection 24(b)(1)(B) as the control of the stocks did not change.

The facts are fully discussed in 41 B. T. A. 892. The Circuit Court of Appeals, affirmed in a brief opinion and certiorari was denied by the Supreme Court. The denial of the certiorari by the Supreme Court cannot be considered as an approval of the decisions of the Court below because the Irrigation Company failed utterly to show that the case was one which involved either a conflict of decisions or "a question of importance which it is in the public interest to have decided by the Court of last resort." *Magnum Co.* v. *Coty*, 262 U. S. 159, 163.

In *Mahaffey* v. *Commissioner*, 1 T. C., p. 176, the Commissioner determined deficiencies of $1,109, $445 and $442 for the years 1936, 1937 and 1938 respectively. Practically the entire amount of deficiency was due to the finding of taxable gain from transactions other than those which could be affected by Section 24 (b) (1) (B). The Tax Court found that the transaction there in question should be viewed as two separate sales, basing its opinion on the *Lakeside Irrigation Company* case. Petitioner appealed, but, obviously in view of the small amount involved in the issue concerning the application of said Section 24 (b) (1) (B), did not appeal on that issue. The C. C. A. reversed.

The amount involved was so small that it does not appear that there was any serious consideration given to the question of the application of said Section 24 (b) (1) (B). Certainly the points here presented were not presented to the Court in that case.

SEVENTH POINT.

The transactions relied upon by the Tax Court and the Circuit Court of Appeals took place after the sale to Mrs. Morris and in no wise contradict appellant's claim of one indivisible transaction.

The offer to purchase by Mrs. Morris and the acceptance by appellant is set forth at pages 16 to 17, *supra*. When the corporate resolution accepting her offer was passed the sale was made and the terms of the sale were fixed. Subsequent to such sale and to facilitate the transfer of certain of the securities included in the sale to Mrs. Morris where the transfer agents were "fussy" it was suggested by the Treasurer of the company who was not a director that a separate proforma resolution to sell two particular stocks be passed so that certified copies might be presented to the "fussy" transfer agents who it was feared might question the general standing resolution authorizing officers to sell all stocks. These resolutions were passed and in answer to counsel for the Commissioner of Internal Revenue, the Treasurer stated that they were merely surplusage (Finding of Fact No. 7, R., p. 16a, Testimony, p. 28a). The above facts surely constitute no base upon which to found a harsh judgment.

The other matter that was commented upon by the Tax Court and by the Circuit Court of Appeals was the form in which the transaction in question was reported upon the tax return of the company. Tax returns are, of course, evidence to show intent or to explain transactions when they are not clear. In the present instance, however, the transaction was clear and was completed months before the tax return was filed and the opinion of the subordinate who prepared and filed the return cannot possibly change the character of the transaction.

Moreover, the Courts below have gone to the limit in hair-splitting in dealing with this return.

The uncontradicted testimony is that the tax return which the company was required to file required a separate statement of the dates of purchase and the dates of sale of each of the stocks sold. Thus, while the date of sale was the same, the date of purchase was different in practically each case and required tabulation (R., pp. 25a-27a).

The Tax Court stresses the point that following this tabulation the return stated that the prices were the market prices of said stocks at the close of September 15, 1941 and puts special emphasis upon the fact that below the tabulation in question, the return used this language "The net loss realized in *these sales* was \$198.21" (Opinion, R., p. 20a).

It was, of course, perfectly natural for the person preparing the return to refer to the tabulation which the company was required to make and which contained a number of separate items as "these sales". However, the reference to the form in which the transaction was reported omits important portions thereof and does not give a correct picture thereof.

The petitioner's Treasurer included in Schedule C of the company's return the following statement:

> "The stocks listed above, having a total acquisition cost of \$131,566.96, were sold and paid for at a total price of \$131,368.75 and delivered September 16th, 1941, to the purchaser, Mrs. K. Clark Morris, chief stockholder and president of this company, the prices being the market prices for said stocks at the close of September 15th, 1941. The net loss realized on these sales was \$198.21" (Respondent's Exhibit "A", Appendix, p. 38a).

The only purpose in making that statement was to point out to the Treasury Department that the transaction was a lump sum sale.

EIGHTH POINT.

Whatever may be said in support of considering the sale of each of the several classes of stock as a separate sale, the sale of certificates of the same class at the same time and for the same price per share should not be considered separate sales.

As already shown, the transaction on September 16th, 1941, consisted of an offer by Mrs. Morris to purchase a prepared list of stocks for $131,368.75.

In effect, the Commissioner contends that the figure of $131,368.75 was arrived at by combining a number of separate purchase prices. Even if this were so, it would not sustain the action of the Commissioner in treating as separate sales and with separate gains or losses the sale of two or more certificates of stock of the same corporation and of the same class at the same time and for the same price per share. Nearly half of the total amount of tax is due to this procedure.

For example, included in the list above were 150 shares of American Telephone & Telegraph Company. However, they were purchased at different times, and comparing the same selling price per share with the different purchase prices, one certificate cost $3,395.07 more than market price while the other cost $2,514.50 less. Also included in said sale were 500 shares of Union Carbide & Carbon Company represented by two certificates, one of which was $7,022.26 more than market price and the other $6,027.16 less (Finding of Fact, No. 9, R., p. 17a).

With respect to each of said two classes of stock, the Commissioner has split the sale into two parts and has charged the taxpayer with income for the gains above referred to, but has disallowed approximately $10,400 of loss.

The transactions of the parties furnish no basis for such an extreme procedure. The only evidence with respect to what took place prior to September 16th was that given by the Treasurer of the Company, Mr. St. Clair and quoted above at page 31 and the formal offer of Mrs. Morris set forth at page 17 *supra.*

Obviously, Mr. St. Clair did not prepare a list which split the 150 shares of stock of the American Telephone & Telegraph Company into two certificates, one of 100 and one of 50 shares, but set forth 150 shares at the market price per share. Therefore, if the Commissioner of Internal Revenue is entitled to disregard what the parties did on September 16th and base his assessment upon the detailed procedure by which the said amount of $131,368.75 was arrived at, he must in any event treat the American Telephone & Telegraph and Union Carbide & Carbon transfers as one transaction each, and not as two each.

The very arguments that support (if it can be supported) the right to split the lump sum sale into the seven different classes, and consider each a separate sale, deny the validity of the splitting up of the separate classes.

Thus, it seems to be the opinion of the Commissioner and of the Court below that the actual form of the transaction adopted by petitioner was contrary to common practice and that parties selling seven different classes of stock would not naturally sell them all for a lump sum, but would price them out separately, giving a market price or a selling price to each class and for that reason the sale should not be considered as one and indivisible.

However, it is just as true that parties selling 150 shares of American Telephone & Telegraph Company stock when the market price was $154.58 per share would not sell 50 shares for $7,731.25 and 100 shares for $15,462.50 as two separate sales, but would sell 150 shares for $23,193.75.

Moreover, the Circuit Court of Appeals in the *Reddington* case, while holding that the transfer of shares of the capital stock of several different corporations should be treated as separate sales because the properties sold were different and had no relation to each other, clearly intimated that where there was a relationship and where it was natural to sell as a whole, the rule which it had laid down would work injustice and should not be invoked. Thus, the Court said:

> "It is perhaps conceivable that there might be some circumstances, even under Sec. 24, where a number of sales of related articles would be regarded as one sale, integrated because of some significant correlating fact. But we are satisfied that here there was not enough to make the many one."

Surely there is such a close relationship between shares of the same company sold in a block that it would be most unreasonable and contrary to common practice to separate such a transaction into two or more separate sales.

NINTH POINT.

The purpose of Congress in enacting Sections 500 to 511 of the Internal Revenue Code imposing a surtax of 85% on undistributed current earnings of personal holding companies was intended to force distributions which would be taxable in the hands of stockholders and was not intended to penalize a corporation by imposing a surtax in a case such as this.

The action of the Commissioner not only imputes $16,915.91 of taxable income where there was in fact no income, but applies an 85% tax to such fictitious income for failure to pay it out (R. 17a). Even if taxpayer had paid out such amount to its stockholders, it would not have been relieved from this tax, according to the claim of the Commissioner of Internal Revenue, as the distribution would not have been taxable to the stockholders.

No such harsh rule was intended by Congress. The Personal Holding Company Surtax first appeared in the Revenue Act of 1934. Its purpose was to force the distribution by personal holding corporations of profits which would be taxable in the hands of the stockholders of such corporations. There already existed in prior Revenue Acts a provision calculated to accomplish the same general purpose, to wit, Section 104 of the Revenue Act of 1932, (entitled "Accumulation of Surplus to Avoid Surtax"), and similar sections in earlier Revenue Acts.

However, determinations by the Commissioner that corporations were formed or availed of for the purpose of avoiding surtax on the stockholders were the subject of litigation.

It was to force more completely the distribution of accumulated corporate earnings into the hands of stock-

holders who would be subject to high Surtaxes that the Personal Holding Company Surtax was adopted. This is made clear by the legislative history of the early Personal Holding Company Acts.

The following comments concerning Personal Holding Company Surtax provisions in the 1934 Revenue Act are found in the Congressional Reports of the 73rd Congress, 2nd Session:

> Report—Ways and Means Com. (73 Cong., 2nd Sess., H. Rept. 704). This report begins as follows:
>
> "Perhaps the most prevalent form of tax avoidance practiced by individuals with large incomes is the scheme of the 'incorporated pocket book.' That is, an individual forms a corporation and exchanges for its stock his personal holdings in stocks, bonds, or other income-producing property. By this means the income from the property pays corporation tax but no surtax is paid by the individual if the income is not distributed."

Again:

> "The effect of this system recommended by your Committee is to provide for a tax which will be automatically levied upon the holding company without any necessity for proving a purpose of avoiding surtaxes. It is believed that the majority of these corporations are in fact formed for the sole purpose of avoiding the imposition of the surtax upon the stockholders." (p. 11, 12)

Again:

> *Report—Senate Finance Committee.* (73rd Congress—2nd Sess. S. Rept. 558). The report begins: "Your committee is of the opinion that it is extremely important *to prevent this type of tax avoidance.*" (P. H. Cos.)

"Many will consider the surtax imposed on these personal holding companies a harsh measure. However, a corporation which falls within this Section because of the nature of its business and the number of its stockholders *can always escape this tax by distributing to its stockholders at least 90% of its adjusted net income. The stockholder will, of course, be subject to the graduated surtaxes upon such distributions. Thus, the Section should work no real hardship upon any corporation except one which is being used to reduce surtaxes upon its shareholders.*"

"Your committee believes that the imposition of a surtax on personal holding companies created to defeat the operation of the surtax on individuals is of the utmost importance and that it will result directly or indirectly in substantially increasing the revenues of the government." (p. 13-15)

Sec. 351 (b)(2) defines "undistributed adjusted net income."

Again:

Report—Ways & Means Comm. (73rd Cong., 2nd Sess., H. Rept. 704):

> "Thus a corporation which falls within this section because of the nature of its business and the number of its stockholders can always escape this tax by distributing to its stockholders at least 90% of its adjusted net income" (pp. 11, 12).

Thus, it is obvious that the purpose of the Personal Holding Company Surtax provision was merely to correct an imperfection in the operation of Section 104 of the earlier acts, and was not to impose taxes for failure to pay out fictitious or theoretical gains which would not be

taxable in the hands of its stockholders and where the corporation could not relieve itself of the tax.

The provisions of the Revenue Acts subsequent to 1934 imposing the Personal Holding Company Surtax, from time to time increased the rate of the Surtax and added a number of provisions governing the determination of Personal Holding Company status and the computation of Personal Holding Company income. The general plan of the Personal Holding Company Surtax, however, remained the same, and the above quoted remarks of the House Ways and Means Committee and the Senate Finance Committee are equally applicable to the Personal Holding Company provisions in all the Revenue Acts from 1934 on.

In the face of the above legislative history, there could not have been any intent on the part of Congress, in enacting the Personal Holding Company Sections, to tax the companies for failing to distribute to their stockholders money which they did not have *and which distribution would not be taxable to the stockholders.*

Even if this Court is of the opinion that a literal interpretation of the Tax Statute supports the Court below, such interpretation should not be accepted. It is well settled that "it is within the power of the Courts to declare that a thing which is within the letter of a Statute is not governed by the Statute because not within its spirit or the intention of its makers. *Holy Trinity Church* v. *U. S.*, 143 U. S. 457, 472; *Lau Ow Bew* v. *U. S.*, 144 U. S. 47, 59; *Hagar Company* v. *Helvering*, 308 U. S. 389."

This Court has not hesitated to interpret statutes in a reasonable and sensible way when a literal construction would not be consistent with the purpose of the legislation or would cause unreasonable penalties or hardships.

Hagar Company v. *Helvering, supra.*

In the above cited case the Supreme Court said, at page 394:

> "All statutes must be construed in the light of their purpose. A literal reading of them which would lead to absurd results is to be avoided when they can be given a reasonable application consistent with their words and with the legislative purpose. * * *"

Conclusion.

The petition for a writ of certiorari should be granted and the decision below reversed.

Respectfully submitted,

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Of Counsel:

Edward L. Blackman,
Walton Clark, Jr.

October 23, 1946.

(1706)

FILE COPY

Supreme Court of the United States

OCTOBER TERM, 1946.

No. 651.

MORRIS INVESTMENT CORPORATION,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF OF PETITIONER UPON ITS PETITION FOR CERTIORARI.

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Supreme Court of the United States

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No.

MORRIS INVESTMENT CORPORATION,
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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF OF PETITIONER UPON ITS PETITION FOR CERTIORARI.

Facts.

No fact is incorrectly stated by respondent, but by omitting certain facts and shifting the emphasis of others, a picture is created which petitioner considers unfair.

Respondent in his brief in opposition to this application, as well as in his briefs to the Courts below, has sought to make it appear that the question of the application of Section 24 (b)(1)(B) is due to the fact that petitioner is a personal holding corporation, a class not in special favor (Respondents' Brief, pp. 6 & 7).

However, that is not the case. Section 24 (b) (1) (B) applies to all transactions between corporations and stockholders where the stockholder owns or controls, directly or indirectly, more than 50% of the stock and is not confined to personal holding companies, while subdivision A applies to

transactions between members of a family, and (C), (D) and (E) each includes another class of taxpayers.

The transaction here in question was put through with Section 24(b)(1)(B) in view and in such form that it was considered that such section could not possibly be applied. Obviously, the transaction would not have been made at all, or in the form adopted, if it had been considered that there was any possibility of a \$20,000 Income Tax where there was no actual profit at all.

In order to insure that the transaction would not fall within the provisions of said Section 24(b)(1)(B), the following precautions were taken.

(1) So that there could be no question concerning their actual value, or the continued control thereof, only stocks actively traded in daily upon the New York Stock Exchange were selected. Thus there could be no claim of any advantage to Mrs. Morris through the purchase thereof from the corporation rather than upon the Stock Exchange and no advantage to the corporation, petitioner, through a sale to Mrs. Morris rather than upon the Stock Exchange (R. 24a).

(2) Stocks were selected whose aggregate cost equalled the price which Mrs. Morris should pay for them (R. 24a).

(3) A Special Meeting of the Board of Directors of appellant was held and at that meeting Mrs. Morris made a formal offer to purchase the said list of stocks for the lump sum of \$131,368.71, their value on the Stock Exchange at the close of business the previous day. No prices were stated or discussed for any individual class of stock (Findings of Fact Nos. 6 and 7, R. 14a, 16a, 24a).

(4) The offer was accepted as made and the officers were directed to take the necessary steps to transfer the stocks in question to Mrs. Morris or her nominees (Finding of Fact No. 7, R. 16a).

(5) All of the stocks were transferred the same day (Note at bottom of R., p. 38a, Respondents' Exh. "A").

(6) The transaction was clearly and deliberately made as one sale and not as a number of separate sales, and would be so considered for any purpose other than taxation.

However, the respondent worked out a substantial taxable gain by comparing the several market prices of the various securities sold with the original costs of each and counting as gains all cases where the market price was above cost, and disallowing as offsets all cases where the market prices were below the original cost.

If the transaction when made was one and indivisible, it so remained. Events transpiring thereafter cannot change this character.

Respondent introduced in evidence and places great emphasis upon three matters which took place subsequent to the sale to Mrs. Morris above mentioned. These were:

> (a) Special resolutions with respect to the stock of the American Telephone & Telegraph Company and the Chesapeake & Ohio Railroad Company to meet the requirements of "fussy transfer agents" (Respondent's brief, p. 9);
>
> (b) The form in which the petitioner's books were kept and the consequent manner of entering the transaction (Respondent's brief, pp. 6, 9);
>
> (c) The form of petitioner's Income Tax Return made in 1942 for the year 1941 (Respondent's brief, p. 9).

There is no dispute as to the facts. Certain things were done after the sale and for purposes that could have no effect on the sale. In such circumstances these subsequent transactions are not relevant or important and cannot be used to change the character of the transaction which was completed on September 16th, 1941.

Furthermore, no one of these circumstances emphasized by the Courts below, and now by the Attorney-General, is in any way inconsistent with petitioner's contentions, nor are all three of them taken together in any way inconsistent therewith, as will be shown in the following points, wherein those matters are discussed.

Moreover, if the position taken by petitioner in "I" following is correct, all of these matters are wholly irrelevant in any view of the matter.

I. Respondent does not dispute petitioner's claim that most of the questions here presented are ones which have affected, and will affect several large classes of taxpayers and either tax or prevent many perfectly proper transactions where there is no actual gain.

Respondent states three times in its brief that there is no conflict of decisions, and at page 7 thereof that therefore "there is no necessity for further review by this Court."

Petitioner has not claimed that there was any conflict of decisions and did not base its application to this Court upon any such theory, but upon the plain and obvious fact that the questions presented were broad ones, affecting large classes of taxpayers which had never been passed upon by this Court and that the law should be settled.

The fact that Congress passed two laws, one in 1934 and one in 1937 with respect to this matter shows that it was dealing with transactions which it recognized were numerous and important.

The scope of this law is broad and covers 6 classes of transactions. These include transactions between all closely related members of a family, and between all corporations and stockholders thereof who own more than fifty per cent of the stock therein. That Congress considered it important to prevent the taking of losses as the result of transactions between the members of any of the said classes is plain, but the Commissioner and the Courts below have so interpreted the statute that it is now used to create fictitious taxable gains.

Petitioner claims that this interpretation is erroneous and contrary to the meaning of the section, particularly when its plain and clear legislative history is considered.

This Court, as now constituted, has placed emphasis upon the well-settled rule that the true intent of Congress in passing an act must prevail over the letter of the law even where the act is plain and clear in its terms (*Haggar v. Helvering*, 308 U. S. 389). This Court should, therefore, consider the broad question whether the Commissioner and the Courts below have not gone far beyond the intent of Congress in applying Section 26(b)(1) in such manner that it not only prohibits the taking of losses, but creates fictitious taxable income where there was no income in fact.

If the rulings of the lower Courts are allowed to stand and if they are erroneous, as claimed by petitioner, then proper transactions where there is no actual gain and no intent to evade the tax will either be prevented or taxed.

It is obvious that these taxed or prevented transactions will be of great number. Actual proof of this, however, is given by the fact that during the short time following the first-known application of this Sec. 24(b)(1) to a lump sum sale in the *Lakeside Irrigation Company* case, six cases have been decided by the Courts. (See Note at bottom of p. 7, Respondent's Brief.)

While it is true that there is no conflict between the decisions of the Circuit Courts of Appeal and that those decisions are all contrary to *this* contention of petitioner, petitioner contends that they are all contrary to the intent of Congress, as shown by a singularly clear legislative history. (See Petitioner's Main Brief, pp. 22-25).

II. The transaction in question, having consisted of the sale of a mass of securities for a lump sum price equal to cost and as there was no separate pricing out of the various classes of securities sold does not come within the letter of Sec. 26 (b) (1), and must be torn apart and separated contrary to the intent of the parties in order to show the gains claimed by the Commissioner. The question whether this can be done, especially in circumstances where the transaction cannot possibly contravene any reasonable intent of Congress, is a broad and important one.

All of the stocks sold were active Stock Exchange stocks. Petitioner could have sold them on the Exchange and Mrs. Morris or her trustees could have purchased the same number of shares of the same classes the next day.

What reasonable object could Congress have in preventing the sale of active Stock Exchange securities at private sale at the market price? One share of A. T. & T. is as good as another and can always be purchased at the market price of the day.

In this connection it must be remembered that petitioner is not asking to be relieved from the letter of the law. It avoided that by making a lump sum sale. It is only asking that it be not pulled under the law by an alleged act of looking through form to substance when the spirit of the law cannot apply (See Pet., pp. 26 to 29).

While the Circuit Court of Appeals assumed to decide this point against petitioner upon the authority of the *Lakeside Irrigation Co.* and *Reddington* cases, those cases were not in point upon this question as it was not shown that the stocks transferred in those cases consisted of Stock Exchange shares, and, indeed, it appeared to the contrary with respect to some of the shares transferred (Pet., p. 32).

It is well known that many corporations, both personal holding and other, own stocks of other companies which are dealt in upon the New York Stock Exchange. If one of those corporations should sell to a stockholder owning more than 50% of its stock one class of Stock Exchange securities at a market price lower than cost an attempt by the seller to deduct the loss incurred would be directly contrary to the letter of Sec. 24(b)(1)(B) and might be prevented for that reason, even though there would seem to be no reason why Congress should object to such a sale.

However, if a corporation owning several classes of Stock Exchange securities, some of which had a market value below cost and some above cost, sold them all to a stockholder owning more than 50% of its stock for a lump sum not less than the aggregate market price and not less than the aggregate cost, both the letter and the spirit of Sec. 24(b)(1)(B) are avoided the net gain only should be taxed. There seems to be no valid reason why the corporation should be compelled to sell its stocks upon the Stock Exchange and pay a brokerage commission in order ot avoid the imposition of a tax upon a theoretical and non-existent gain.

Emphasis is given to appellant's contention by the fact that for many years the rule has been established that Section 24(b)(1)(B) and its predecessor section 24(a)(6), did not apply to sales made upon the New York Stock Exchange, even though such sales were made for the ex-

press purpose of taking losses and were made in such manner that there was no actual change in control of the stocks sold.

Thus, where the widower and executor of a rich deceased wife, for the express purpose of taking losses, placed orders to sell certain of his wife's securities, and at the same time placed orders to purchase the same quantity of the same securities at the same price for himself individually, and where the transaction resulted in his actually purchasing some of the identical shares sold, it was held that the losses to the estate were legitimate ones and that the transaction did not fall within the provisions of Section 24(b)(1)(B) or any other restrictive provision.

McWilliams v. *Commissioner*, 5 T.C. ~~57 C.~~ 623. See also *Matter of Eichelheimer*, 135 Fed. (2) 660.

III. The particular stocks which were sold were selected because the aggregate cost thereof was almost exactly $131,368.75 (the price paid by Mrs. Morris), and the parties desired to buy and sell at cost, therefore if the transaction is split up it must still be considered as a transaction at cost.

The fundamental condition for selecting the stocks to be sold was that they would be sold for their aggregate cost, and whether they be considered as one lump sum transaction or several transactions, that fundamental condition and intent should prevail.

Of course, there can be no objection to the sale by petitioner at cost of those of the securities in question which had a market value less than cost. Neither can there be any objection to the sale at cost of those securities which had a market value in excess of cost, because for many years it has been the settled law that there is no objection to a

sale at cost even though market value is far in excess of cost and that no taxable income results to any one from such a transaction. *Fincke* v. *Commissioner,* 39 B. T. A. 510.

This is a point which clearly was not involved in any of the decided cases and which may well apply to numerous transactions, although not nearly so broad a question as the two preceding ones.

IV. The Circuit Court in the case at bar has gone far beyond any other Circuit Court decision in holding that not only may the lump sum sale in question be split up into separate sales of the classes of stock sold but that each class may be split up into the separate certificates, making up the quantity sold and each certificate considered as a separate sale.

Thus, 150 shares of American Telephone & Telegraph Co. which cost $24,074.32 and which had a market price of $23,193.75, or $880.57 less than the cost, was so treated that a taxable gain of $2,514.50 was charged against petitioner. This was arrived at by taking a profit of said amount of $2,514.50 upon 50 shares bought in 1933, but denying a loss of $3,395.07 upon 100 shares bought in 1929. (R 38a)

There seems to be no warrant or excuse for such extreme procedure and it is contrary to the theory on which the lump sum sale was broken down into the several classes of stock sold. The theory for that breakdown seems to be that the transaction in the lump sum form was contrary to what would generally take place and that ordinarily each class of security would be sold at the market price thereof rather than at one lump sum for the entire amount. But this theory is completely ignored when it came to splitting up each separate class into the individual certificates which

composed it. For clearly no seller intending to sell 150 shares of stock to a buyer all at the same time and same price would make two separate sales of the transaction.

If the rule of the Court below were applied to farmers, grain merchants and others it would cause great confusion and hardship.

V. None of the preceding points, except that set forth in "I" above, could have been passed upon by any of the decisions of the circuit courts cited by respondent.

At page 7 of his brief, respondent cites six cases where Circuit Courts have passed upon the application of Section 24 (b)(1). However, in none of those cases was it shown that the separate classes of stock sold were not separately priced. In none of them was it shown that the stock sold consisted wholly of securities dealt in daily upon the New York Stock Exchange, and in none of them was there any attempt made to sell at cost. For the above reasons, none of those decisions is in any way controlling upon the points raised by this petitioner, except its Point I, wherein it contends that the plain intent of Congress, as shown by the legislative history of Section 24 (b)(1)(B), was merely to prevent the deduction of losses and not to create fictitious gains and tax alleged profits which did not exist.

VI. None of the transactions of petitioner after the sale affected the character thereof and none of them is inconsistent with its contentions here made.

The special resolution with respect to the shares of American Telephone & Telegraph Company and the Chesapeake & Ohio Railroad Company was made after the sale to Mrs. Morris had been made and was completed as one

indivisible transaction. The resolution was made solely as a matter of form and to meet anticipated objections from the Transfer Agents of the two companies, who were considered "fussy". In the words of the witness, St. Clair, who proposed the resolutions, they were merely surplusage and a precaution against the rejection by the "fussy" Transfer Agents of the standing resolution of the Company generally authorizing the officers to make sales of its securities (R. 28a).

The form in which a corporation has kept its books certainly cannot transform one indivisible transaction into twenty-one separate ones. Especially is this so when the form of bookkeeping was adopted to comply with the regulations of the Treasury Department. Nor does the fact that the form in which the books have been kept for years required the entry of the transaction against separate accounts for the various stocks sold, in any way affect the fact that the transaction was intended to be and was in fact one sale (R. 25a, 27a).

The form in which the witness, St. Clair, who was only a Clerk, but called Treasurer of the Company, made up the Income Tax Return is entirely consistent with and sustains petitioner's contentions. Much was made by respondent of the fact that, in preparing petitioner's Income Tax Return for the year 1940, St. Clair set forth twenty-one different items.

However, St. Clair explained and there was no dispute on the point that the Treasury Regulations required the date of purchase and the purchase price to be set down separately with respect to each certificate of stock sold, and that he merely complied with such regulation (R. 27a). However, the fact that he appended to the tabulation a statement that the stocks were all sold to Mrs. Morris for a lump sum price shows that there was no departure by the Company from that contention (R. 38a).

VII. The Court should not give a harsh and unreasonable interpretation to Sections 500 to 511.

Petitioner concedes that according to the letter of the above laws it is liable to tax if the transaction in question is held to result in taxable gain. However it must be admitted that to apply such a tax in the present instance is most harsh.

As was shown in petitioner's main brief to this Court upon this application, pages 43 to 47, it was the intent of Congress solely to force corporations to distribute taxable income to their stockholders so that such income might be taxed and revenue obtained therefrom. In the case at bar, the gain is wholly fictitious, and if petitioner had distributed to its stockholders the amount alleged to constitute gain, such distribution would not have been taxable in their hands and therefore petitioner could not have escaped tax thereon. It does not seem reasonable that Congress should have had such an intent.

This is a very different situation from the cases of deficit corporations which have been ruled upon by this Court.

Conclusion.

The petition should be granted and the writ issued.

Respectfully submitted,

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Of Counsel:

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December 5, 1946.

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CITATIONS

722104—46

In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 651

MORRIS INVESTMENT CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 13–21) [1] are reported in 5 T. C. 583. The opinion of the Circuit Court of Appeals (R. 43–49) is reported in 156 F. 2d 748.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 25, 1946. (R. 49–50.) The petition for certiorari was filed October 25, 1946.

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[1] Record references are to pages of the appendix to the brief for petitioner in the Circuit Court of Appeals.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Did both the Tax Court and the Circuit Court of Appeals err in holding that the taxpayer, a personal holding company within the meaning of Section 501 (a) (2) of the Internal Revenue Code, which sold stock in various corporations to its principal stockholder at market prices for a lump sum, resulting in gains as to some and losses as to others, was taxable on the gains and was prohibited by Section 24 (b) (1) (B) of the Internal Revenue Code from offsetting losses against the gains and from claiming a deductible net loss for the year 1941?

2. Did the courts below err in holding that the taxpayer is subject to the personal holding company surtax imposed by Section 500 of the Internal Revenue Code, as amended by Section 110 (a) (2) of the Revenue Act of 1941, on its undistributed subchapter A net income and was prohibited by the provisions of Section 504 (a) from taking a credit as a deficit corporation under the provisions of Section 27 (a) (3)?

STATUTES INVOLVED

The applicable provisions of the statutes involved are set out in the Appendix, *infra*, pp. 12–14.

STATEMENT

The facts as found by the Tax Court may be summarized as follows:

The taxpayer, Morris Investment Corporation, was incorporated December 31, 1928, under the laws of Delaware. For the taxable year 1941 it filed a corporation income and declared value excess profits tax return and a personal holding company tax return. (R. 13–14.)

During the taxable year 1941 the taxpayer was a personal holding company. Mrs. Katherine Clark Morris was president of the taxpayer and during the taxable year 1941 owned 91.87 per cent of the 31,000 outstanding shares of its common capital stock. The remainder of the stock was held by the estate of her late husband, L. R. Morris, and by her daughter and son-in-law.[2] (R. 14.)

At a special meeting of the board of directors of the taxpayer, held on September 16, 1941, Mrs. Morris offered to purchase certain stocks[3] owned

---

[2] Section 501 (a) (2) of the Internal Revenue Code defines a personal holding company as one in which more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

[3] These stocks were (R. 15):

700 shares of capital stock of Amerada Corporation
150 shares of capital stock of American Telephone & Telegraph Company
500 shares of capital stock of Union Carbide & Carbon Corporation
25 shares of common stock of Atchison, Topeka & Santa Fe Railway Co.

by the company. (R. 14–15.) The offer was accepted. (R. 15.)

The purchase price was the aggregate of the market prices of the stocks sold, at the close of September 15, 1941. All the stocks were actively traded in on the New York Stock Exchange. A note for $131,368.75, given by Mrs. Morris in payment, was never paid. (R. 16.)

With respect to the shares in American Telephone & Telegraph Company and Chesapeake & Ohio Railway Company, specific resolutions were adopted, providing that the company sell Mrs. Morris 150 shares of American Telephone & Telegraph Company stock at a price of 154⅝ per share, and 200 shares of the common stock of the Chesapeake & Ohio Railway Company at a price of $37.25 per share. (R. 16.)

The stocks purchased by Mrs. Morris were delivered to three trust companies in New York City with whom Mrs. Morris had arranged to establish trusts for the benefit of her daughter and her grandchildren. (R. 16.)

The following gains or losses resulting from the sale were reported by the taxpayer in its income tax return for the taxable year 1941 (R. 17):

---

200 shares of common stock of Chesapeake & Ohio Railway Company
150 shares of common stock of Union Pacific Railroad Company
150 shares of common stock of Corn Products Refining Company

Description of property	Date acquired	Gross sales price	Cost	Gain	Loss
100 American Telephone & Telegraph Co.	3/27/29	$15,462.50	$18,857.57		$3,395.07
50 American Telephone & Telegraph Co.	1/30/33	7,731.25	5,216.75	$2,514.50	
25 Atchison, Topeka & Santa Fe Ry. Co. Common	10/ 8/29	675.00	6,933.75		6,258.75
200 Amerada Corporation	4/17/34	11,800.00	10,072.50	1,727.50	
100 Amerada Corporation	4/18/34	5,900.00	5,292.50	607.50	
200 Amerada Corporation	4/21/34	11,800.00	10,585.00	1,215.00	
100 Amerada Corporation	5/14/34	5,900.00	4,690.00	1,210.00	
100 Amerada Corporation	7/30/34	5,900.00	4,290.00	1,610.00	
150 Corn Products Refining Corp. Common	1/30/33	7,875.00	8,313.04		438.04
200 Chesapeake & Ohio Ry. Common	2/ 2/33	7,450.00	5,780.00	1,670.00	
300 Union Carbide & Carbon Corporation	1/ 2/29	23,550.00	17,522.84	6,027.16	
100 Union Carbide & Carbon Corporation	9/ 9/29	7,850.00	12,662.14		4,812.14
32 Union Carbide & Carbon Corporation	10/17/29	2,512.00	3,425.02		913.02
68 Union Carbide & Carbon Corporation	3/25/30	5,338.00	6,635.10		1,297.10
150 Union Pacific R. R. Co. Common	1/30/33	11,625.00	11,290.75	334.25	
Total		$131,368.75	$131,566.96	$16,915.91	$17,114.12

In that return the taxpayer reported a net long-term capital loss of $198.21. (R. 17.) The following statement was attached to the return (R. 18):

> The stocks listed above, having a total acquisition cost of $131,566.96, were sold and paid for at a total price of $131,368.75 and delivered Sept. 16, 1941, to the purchaser, Mrs. K. Clark Morris, chief stockholder and president of this company, the prices being the market prices for said stocks at the close of September 15, 1941. The net loss realized on these sales was $198.21.

The taxpayer kept no general investment account on its books. Each certificate of stock held by the taxpayer, including those sold to Mrs. Morris on September 16, 1941, was kept in a separate account on the company's books and accounted for separately, so that the taxpayer could tell what the adjusted acquisition cost of such certificate was at any time to apply against any ultimate realization, and to collate tax returns easily. After the sale to Mrs. Morris, entries were made in the separate accounts of each certificate on the books to record the sale. The amount entered as sale price was the price at which the stock had sold at the last sale prior to September 15, 1941. (R. 18.)

The taxpayer had a deficit of $10,420.51 on December 31, 1940, and at the close of December 31, 1941, had a deficit of $11,144.73. Its earnings were paid out at the end of the year. (R. 18.)

Under the provisions of Section 24 (b) (1) (B) of the Internal Revenue Code, the Commissioner denied the taxpayer any loss on the stocks sold to Mrs. Morris but included the gains as taxable income. (R. 13.) He determined that the taxpayer was subject to a personal holding company surtax and found a deficiency in income tax of $6,965.89 and a deficiency in personal holding company surtax of $13,301.67. (R. 13.)

The Tax Court sustained the deficiencies in tax as found by the Commissioner (R. 22), and the

Circuit Court of Appeals for the Third Circuit affirmed that decision (R. 50).

ARGUMENT

1. There is no conflict of decisions; and in view of the settled construction of the statutory provisions by the decided cases,[5] there is no necessity for further review by this Court. The taxpayer's attempt to distinguish the cases relied upon by the Government was not convincing either to the Tax Court (R. 19–20) or to the Circuit Court of Appeals (R. 46–48).

The applicable statutes (Appendix, *infra*) are clear and unambiguous. The taxpayer is a personal holding company (R. 14) under the definition of Section 501 (a) (2) of the Internal Revenue Code. Being a personal holding company it is taxable on the gains derived from the sale of stock to its principal stockholder under Section 22 (a) of the Code and is prohibited by Section 24 (b) (1) (B) from offsetting losses on other stocks sold to its principal stockholder or from taking a deduction for any net loss. The decisions have laid down the rule that where there are sales of various securities for an aggregate

[5] *M. F. Reddington Co.* v. *Commissioner*, 131 F. 2d 1014 (C. C. A. 2d); *Lakeside Irr. Co.* v. *Commissioner*, 128 F. 2d 418 (C. C. A. 5th), certiorari denied, 317 U. S. 666; *Mathews* v. *Squire*, 59 F. Supp. 827 (W. D. Wash.); *W. A. Drake, Inc.* v. *Commissioner*, 3 T. C. 33; *Mahaffey* v. *Commissioner*, 1 T. C. 176, reversed on another issue, 140 F. 2d 879 (C. C. A. 8th).

sum, the gain or loss on each block must be separately computed. The limitation prescribed by Section 24 (b) (1) (B) of the Code is clearly within the power of Congress since the allowance of deductions is not a matter of right but of legislative grace.[6]

The taxpayer admits (Br. 25) that its first and principal point (Br. 19–25) is inconsistent with the cases. Moreover, each purchase of a security results in a separate cost and a separate holding period. Therefore, it is proper to treat the disposition of each security as a separate transaction, whether or not it is sold in conjunction with others. Accordingly, the rule applied here is generally applicable, and differences in detail such as those relied upon by the taxpayer (Br. 32–37) do not distinguish the earlier cases. The rule applied herein is the general rule applicable in computing gain or loss in all sales of securities and is not confined in its application solely to personal holding companies.

Equally unsound are taxpayer's second (Br. 26) and fourth contentions (Br. 29–30) that by selling for a lump sum the separate securities were merged into a single and indivisible whole. Moreover, the Tax Court disagreed with the taxpayer's statement (Br. 13) that the transaction was an "*integral lump sum* sale of several classes

[6] *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; ***White*** v. *United States*, 305 U. S. 281, 292; *Deputy* v. *du Pont*, 308 U. S. 488, 493.

of stock not separately priced". (R. 19–20.) By resolution, as to some of the stocks sold, the taxpayer made a division (R. 16) and it kept the various lots separately listed on its books showing the date of acquisition, gross sales price, cost and the resulting gain or loss from each lot sold (R. 17). See also Schedule C of the income tax return filed for the year 1941 showing separate treatment of each lot of stock sold. (R. 38–42.)

The taxpayer's third contention (Br. 27–28) erroneously assumes that authority for the rule applied here must be found in Section 24 (b) (1) (B). Even upon that assumption the application of the statute is not limited to bona fide sales or cases of subsequent control by the seller over the property sold but covers other situations as well.

The taxpayer's remaining points are likewise without merit. Its assertion (Br. 30) that it did not sell any of the stocks at a loss is not borne out by the record. (R. 17.) That the taxpayer intended to sell at cost (Br. 30–32) is beside the point since what was done is controlling.[7]

2. Lastly, the taxpayer argues (Br. 43–47) that the purpose of Sections 500–511 was to force distributions which would be taxable in the hands of stockholders. That undoubtedly was one of the purposes of the enactment but other cases also fall within the ambit of the statute. It is also

[7] *Davidson* v. *Commissioner*, 305 U. S. 44, 46; *United States* v. *Safety Car Heating Co.*, 297 U. S. 88, 98.

contended (Pet. 7, Br. 16, 43–47) that, because the taxpayer was a deficit corporation without earnings to distribute, it is not subject to the personal holding company surtax. Section 27 (a) (3) of the Code allows a dividends paid credit to deficit corporations but that section does not apply to personal holding companies and the taxpayer is not entitled to any dividends paid credit in computing its undistributed subchapter A net income for the year 1941 although the taxpayer was a deficit corporation at the beginning and end of the year 1941.[8]

Subchapter A of Chapter 2 of the Code relates exclusively to personal holding companies and provides for a surtax on undistributed subchapter A net income of such companies. Section 504 of that subchapter defines the term undistributed subchapter A net income as subchapter A net income minus the amount of the dividends paid credit provided in Section 27 (a) without the benefit of paragraphs 3 and 4 thereof. The taxpayer here must rely upon Section 27 (a) (3) as a deficit corporation but Section 504 (a) of the Code expressly excludes a personal holding company from the benefits generally accorded a deficit corporation.

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[8] *Morris Inv. Corp.* v. *Commissioner*, 134 F. 2d 774, 775 (C. C. A. 3d), certiorari denied, 320 U. S. 743.

CONCLUSION

There is no conflict of decisions, and the decision of the Circuit Court of Appeals is correct; the petition for a writ of certiorari should therefore be denied.

Respectfully submitted,

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November, 1946.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 22.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

* * * * *

(b) *Losses from Sales or Exchanges of Property.*—

(1) *Losses Disallowed.*—In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly—

* * * * *

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in

value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; * * *.

* * * * *

(26 U. S. C. 24.)

SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

(a) *Definition in General.*—As used in this chapter with respect to any taxable year the term "dividends paid credit" means the sum of:

* * * * *

(3) The amount, if any, by which any deficit in the accumulated earnings and profits, as of the close of the preceding taxable year (whether beginning on, before, or after January 1, 1939), exceeds the amount of the credit provided in section 26 (c) (relating to net operating losses), for such preceding taxable year (if beginning after December 31, 1937); * * *

* * * * *

(i) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this chapter for the period in which the distribution is made, such part shall not be included in computing the basic surtax credit.

(26 U. S. C. 27.)

SEC. 500 [as amended by Section 110 (a) (2) of the Revenue Act of 1941, c. 412, 55 Stat. 687]. SURTAX ON PERSONAL HOLDING COMPANIES.

There shall be levied, collected, and paid, for each taxable year beginning after De-

cember 31, 1938, upon the undistributed subchapter A net income of every personal holding company (in addition to the taxes imposed by chapter 1) a surtax equal to the sum of the following:

(1) 71½ per centum of the amount thereof not in excess of $2,000; plus

(2) 82½ per centum of the amount thereof in excess of $2,000.

(26 U. S. C. 500.)

SEC. 501. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) *General Rule.*—For the purposes of this subchapter and chapter 1, the term "personal holding company" means any corporation if—

*　*　*　*　*

(2) *Stock Ownership Requirement.*—At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

*　*　*　*　*

(26 U. S. C. 501.)

SEC. 504. UNDISTRIBUTED SUBCHAPTER A NET INCOME.

For the purposes of this subchapter the term "undistributed subchapter A net income" means the subchapter A net income (as defined in section 505) minus—

(a) The amount of the dividends paid credit provided in section 27 (a) without the benefit of paragraphs (3) and (4) thereof.

*　*　*　*　*

(26 U. S. C. 504.)

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